Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Houston	Analyst:	Victoria Favorito	Bill Number:	AB 6
Related Bills:	See Legislative History	Telephone:	845-3825	Amended Date:	January 7, 2008
		Attorney:	Doug Powers	Sponsor:	

SUBJECT:	Depreciation Deduction/Qualified Capital Expenditures & Qualified Capital Investments

SUMMARY

This bill would provide an alternative depreciation deduction to personal income tax (PIT) and corporate taxpayers for the cost of acquiring machines or equipments that can reduce greenhouse gas emissions.

SUMMARY OF AMENDMENTS

The bill would remove Health and Safety Code provisions relating to greenhouse gases and market-based compliance mechanisms and would add Revenue and Taxation Code sections relating to an alternative depreciation deduction for specified qualified capital expenditures and qualified capital investments that measurably reduce greenhouse gas emissions from a qualified facility.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's office, this bill would encourage the acquisition of property that would measurably reduce greenhouse gas emissions.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2009.

POSITION

Pending.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
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ANALYSIS

FEDERAL/STATE LAW

Depreciation

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in the production of income or property used in a trade or business. The amount of this deduction is determined, in part, by the cost (or basis) of the property. In addition, the property must have a limited, useful life of more than one year. The depreciation deduction is generally allowed over a period approximating the property's economic life rather than deducted in the year purchased or acquired.

Existing federal law uses the Modified Accelerated Cost Recovery System (MACRS) for property placed in service after 1986. Under MACRS, the depreciation deduction is computed using the "applicable depreciation method," the "applicable recovery period," and the "applicable convention." MACRS provides three applicable depreciation methods: 200% declining balance, 150% declining balance, and straight-line. The applicable recovery period ranges from three to 50 years, depending on the type of property. The applicable convention requires that property placed in service be treated as placed in service on the mid-point of either the taxable year (half-year convention), the month (mid-month convention), or the quarter (mid-quarter convention).

Existing federal law provides an alternative depreciation system (ADS), which provides generally longer recovery periods than the standard MACRS recovery periods and requires use of the straight-line depreciation method. Six types of property are subject to ADS: (1) tangible property used predominantly outside the United States, (2) tax-exempt use property, (3) tax-exempt bond financed property, (4) imported property covered by an Executive Order, (5) property for which the taxpayer has made an election, and (6) any plants produced in a farming business for which the taxpayer has made an election to exempt the crop from the uniform capitalization rules.

Under the existing Personal Income Tax Law (PITL), California generally conforms to the federal MACRS and ADS. Existing state Corporation Tax Law (CTL) does not conform to the federal MACRS or ADS. Instead, property must be depreciated over its estimated useful life, which is the period over which the asset may reasonably be expected to be useful in the trade or business. Taxpayers may elect to use the useful life specified under the federal Class Life Asset Depreciation Range System (ADR). ADR groups assets into more than 100 classes and assigns an asset guideline period, or useful life, to each class. For purposes of grapevines (in the agricultural class), the ADR asset guideline period is 10 years.

Current California law uses the following depreciation methods for tangible property:

1) Straight-line method,
2) 200% declining balance method,
3) Sum of the years-digit method, and

4) Any other consistent method productive of an annual allowance that, when added to all allowances for the period commencing with the taxpayer's use of the property, exceed the total of those allowances that would have been used had those allowances been computed under the 200% declining balance method.

Methods under (2), (3), and (4) above may be used for tangible property with a useful life of three or more years.

As an incentive for businesses to invest in property, occasionally an accelerated depreciation deduction is allowed. That is, a deduction is allowed at a faster rate than the decline in the property's economic value would warrant.

THIS BILL

This bill would allow taxpayers to elect under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL)an alternative depreciation deduction for "qualified capital expenditures" and "qualified capital investments."

The bill would define the following terms:

- "Qualified capital expenditures" are engines, boilers, generators, and other tangible personal property that measurably reduce greenhouse gas emissions from a qualified facility.
- "Qualified facility" means both the following:
  - an existing facility of the taxpayer,
  - the expansion of an existing facility of the taxpayer, in the same location as, or adjacent to, an existing facility of the taxpayer.
- "Qualified capital investments" means equipment used to produce, generate, or store renewable energy from biomass, solar, wind, and hydrogen sources.

This bill would allow taxpayers to elect to take the deduction for the entire amount of qualified capital expenditures and qualified capital investments over three years, starting with the year the expenditures and investments are paid or incurred, and the two subsequent years, using the straight line method of depreciation.

This bill does not specify if the qualified property must be used in California or whether it may be used anywhere.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill would allow a taxpayer to elect the straight-line method of depreciation over a three-year time period in place of any other allowable depreciation method. The bill is silent about whether the election is irrevocable. As a result, the department would treat the election as though it were revocable. This would allow a taxpayer to change the method of depreciation at any time during the three-year period. If that is not the author's intention, the bill should be amended to specify that the election, once made, would be irrevocable.

This bill would disallow the deduction unless the taxpayer is in compliance with any requirements relating to statewide greenhouse gas emission levels imposed pursuant to the Health and Safety Code. FTB staff lacks expertise in greenhouse gas emission requirements. The author may wish to consider having a qualified third-party, such as CalEPA, certify that the taxpayer is in compliance with the statewide greenhouse gas emission requirements.

Because this bill would not specify whether the "qualified facility" must be located within California or whether the qualified property must be "placed in service" within California to be eligible for the election, a taxpayer may be able to claim the deduction for property purchased in California and transferred to an out-of-state facility.

This bill would specify that no other depreciation deduction would be allowed for the same expenses for which the deduction in this bill allowed. However, the bill is silent about whether the taxpayer would be allowed other deductions or credits for the property in this bill.

TECHNICAL CONSIDERATIONS

This bill uses the terms "other tangible personal property" as a part of the definition of "qualified capital expenditures" and "equipment" in the definition of "qualified capital investments". It is unclear If the author intends to apply the deduction to properties described in IRC section 1245(a)(3)(B). The author may wish to clarify between "tangible personal property" and "other tangible property." Tangible property is a broader term that includes certain types of real property and personal property that becomes affixed.

This bill does not limit the deduction to assets "placed in service" in California. Thus, a taxpayer could purchase the property in California and transfer it to an out-of-state use and claim the special deduction allowed under this bill.

On page 2, line 7, of this bill as amended January 7, 2008, delete "in 3 years" and insert "over 3 years".

LEGISLATIVE HISTORY

AB 1651 (Arambula, 2007/2008) would enact a tax credit for equipment used to reduce greenhouse gas emissions. The bill is currently in the Assembly Revenue and Taxation Committee.

PROGRAM BACKGROUND

According to the scientific community, climate change poses a serious threat to California's economic well-being, public health, and environment if aggressive actions to reduce greenhouse gas emissions are not taken soon. In response to the warning from the scientific community, AB 32 (Nunez 2005/2006), the Global Warming Act of 2006, codifies the state's goal of reducing global warming emissions by 25% by 2020.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a credit/deduction comparable to the credit/deduction allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 6 as Amended 1/7/08 Effective for Taxable Years BOA 1/1/08 ($ In Millions)		
2008-09	2009-10	2010-11
-$21	-$94	-$214

Enactment is assumed after June 30, 2008. This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The bill proposes an alternative method of depreciation that allows an accelerated write-off of specified equipment and investments. Taxpayers that elect the proposed accelerated method of depreciation for qualified capital equipment and investments and the tax rate of taxpayers making such an election would determine the revenue impact of this bill.

The survey of Annual Capital Expenditures for 2005 indicates businesses nationwide spent $744.4 billion for equipment. It is not known how much was spent for qualified capital equipment and investments as specifically defined in the bill. Using income and expenditure data from industries most likely to use the property in this bill, it is assumed 5% of the $744.4 billion would be spent on such equipment and investments, or $37.2 billion at the 2005 level ($744.4 billion x 5%). The $37.2 billion is grown by the forecast in corporate profits as projected by the

Department of Finance to derive a projection at the 2008 level, or $53.1 billion. It is assumed that one-fifth of the $53.1 billion is incurred by individuals, or $10.6 billion, and four-fifths by other business entities, or $42.4 billion.

With respect to the $10.6 billion projected for individuals, it is assumed California personal income tax (PIT) taxpayers would incur 12.5%, or about $1,325 million ($10.6 billion x 12.5%). Under present law depreciation provisions, the estimated useful life of qualified capital expenditures and investments ranges mostly from five to ten years. Under the bill, the useful life would be three years. Assuming an average useful life of 7.5 years under present law, the depreciation deduction is $177 million ($1,325 million divided by 7.5 years). As proposed in the bill, the depreciation deduction would be $442 million ($1,325 million divided by 3 years). The difference between the present law depreciation deduction and the proposed depreciation deduction is the incremental deduction benefit under this bill. The incremental deduction benefit for PIT taxpayers is projected at $265 million for 2008 ($177 million less $442 million). Applying an average marginal tax rate of 8% results in a potential revenue loss of $21.2 million ($265 million x 8%). Also applied is a rate at which taxpayers are anticipated to elect the alternative depreciation method under this bill. The rate at which this election is made would range from 60% of taxpayers in 2008 to 95% by 2011. For 2008, applying the 60% rate results in a revenue loss of $12.7 million for PIT taxpayers ($21.2 million x 60%).

With respect to the $42.4 billion of equipment and investment expenditures incurred by other business entities, it is assumed that three-quarters of these expenditures, or $31.8 billion, are incurred by entities having franchise or income tax nexus in California ($42.4 billion x ¾). As currently drafted, this bill does not require that qualified capital equipment be installed at a qualified facility in California or that investments for renewable energy be made in California. As for PIT taxpayers above, a similar calculation is performed to derive the incremental deduction benefit under the bill for CTL taxpayers. The incremental deduction benefit is projected to be $6.4 billion in 2008 for these taxpayers. Applying an average apportionment factor of 10% and a tax rate of 8% results in an additional potential revenue loss of $51 million at the 2008 level ($6.4 billion x 10% x 8%). Also applied is a rate at which taxpayers are anticipated to elect the alternative depreciation method. The rate ranges from 60% of taxpayers in 2008 to 95% by 2011. For 2008, applying a rate of 60% results in a revenue loss of $30.6 million for CTL taxpayers ($51 million x 60%).

For the bill, revenue losses total $43.3 million for the 2008 taxable year ($12.7 million for PIT taxpayers and $30.6 million for CTL taxpayers). Initially, revenue losses increase each additional year as the result of adding another vintage of electing taxpayers. Beginning with the fourth taxable year, losses begin declining somewhat because, for each additional vintage of depreciable assets added, a prior vintage is fully depreciated under the bill. Also, under the bill, deductions are accelerated. Once a vintage of assets is fully depreciated under the bill, there are offsetting adjustments for depreciation otherwise deductible under present law. Taxable year estimates have been converted to the fiscal year estimates in the table.

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